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OFFICE OF THE SECRETARY

EX PARTE OR LATE FILED

April 10, 2001

Magalie Roman Salas
Secretary
Federal Communications Commission
Room TW-A325
445 12th Street, S.W.
Washington, D.C. 20554

Re: CC Docket No. 96-262

Dear Ms. Salas:

On April 9th I met with Commissioner Gloria Tristani and her legal advisor, Sarah Whitesell, to discuss the contents of the attached April 6th Ex Parte filed on behalf of Allegiance Telecom, Time Warner Telecom and XO Communications.

In accordance with Section 1.1206(b) (1), I am filing two copies of this notice in the docket identified above.

Sincerely,

Kevin M. Joseph

Kevin M. Joseph
Vice President
Government Affairs

Attachment

cc: Commissioner Tristani
Sarah Whitesell

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

April 6, 2001 ***EX PARTE***

Magalie Roman Salas
Secretary
Federal Communications Commission
Room TW-A325
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *CC Docket No. 96-262*

Dear Ms. Salas:

In *ex parte* letters recently filed in the above-referenced docket, AT&T has argued that the Commission should require that CLEC interstate switched access rates be reduced to 1.2 cents per minute immediately and subsequently to the relevant ILEC rate within twelve months.[1] As explained below, the Commission should not adopt the AT&T proposal for the following reasons.

- The AT&T proposal would constitute an arbitrary departure from the FCC's treatment of ILEC interstate access rates. The Commission has never required a flash-cut reduction in ILEC access rates that even approaches the reduction proposed by AT&T. The most significant recent reduction in ILEC access rates was implemented as part of the CALLS plan. But the per minute rate reductions in the initial years of that plan are more than made up in higher revenues toward the end of the five-year period. Moreover, those ILECs that do experience significant net losses in revenues over the life of CALLS are given a special glide path over the five-year period.

[1] *See* Letter from Robert W. Quinn, Jr., Vice President, Federal Government Affairs, AT&T to Ms. Magalie Roman Salas, CC Docket No. 96-262, DA-1067, DA 00-1268 (March 22, 2001); Letter from Patrick H. Merrick, Esq., Director - Regulatory Affairs, AT&T Federal Government Affairs to Ms. Magalie Roman Salas, CC Docket No. 96-262, DA-1067, DA 00-1268 (March 16, 2001).

- The Commission has also allowed a gradual transition for rate changes affecting new entrants into competitive markets. The most relevant example of this policy is tandem switched transport. New entrant long distance carriers generally use tandem switched transport to carry traffic from their POPs to ILEC end offices. This is because the small long distance carriers do not have adequate traffic volumes to justify more efficient direct trunked transport arrangements. As part of the *MFJ* (from 1984 until 1991) and later as part of Commission policy (from 1991 through 1997), tandem switched transport was subsidized to allow the new entrants to achieve adequate scale to compete with AT&T. When the Commission finally decided to implement cost-based tandem switching charges in 1997, it allowed a nearly three-year transition for implementation. Long distance entrants were therefore given *16 years* to build adequate scale to compete with the incumbent.

- Thus, to the extent the Commission decides to lower CLEC access rates, it must grant CLECs an adequate transition to adjust their businesses. At the very least, the Commission should establish an initial benchmark rate of no less than 2.5 cents, applicable on a prospective basis and above which CLECs would be subject to mandatory detariffing. The Commission should then lower the benchmark in equal annual increments so that it reaches parity with the ILEC rate by the end of the CALLS plan (June 30, 2005).[2] This plan drops CLEC access rates an estimated 60 percent on average in the first year of the plan, a significant reduction by any measure. Moreover, the plan provides about a four-year transition for rate reductions that are much larger than those included in the five-year CALLS plan. Finally, the approximately four-year transition period is more appropriate than the nearly three years given for tandem switched transport, since CLECs have not benefited from anything close to the fourteen-year preliminary period granted to small long distance carriers.

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[2] Time Warner Telecom ("TWTC"), Allegiance Telecom ("Allegiance"), and XO Communications ("XO") submit that the access rates they currently charge are not unjust, unreasonable, or in any way unlawful. In addition, the Commission's proposal to regulate CLEC access is inconsistent with the deregulatory intent of the Telelcommunications Act of 1996. In presenting the arguments in this letter, these CLECs do not mean to concede in any way the need for reducing CLEC access rates below their current levels. Rather, this filing is written in the spirit of proposing a compromise position for prospective treatment of CLEC charges in order to resolve the difficult and complex issues raised in this proceeding.

The AT&T proposal would single out CLEC access rates for flash-cut reductions when in other analogous contexts the Commission has gradually phased-in rate changes to allow carriers to adjust their businesses. In the two most closely analogous contexts, ILEC interstate switched access charges and tandem switched transport purchased by long distance carriers, the Commission has gone out of its way to establish extended transition periods to allow the affected carriers to adjust to the new regulatory environment caused by major changes in regulated rates.

In the case of ILEC access charges, the Commission has never allowed a flash-cut change in rates that comes anywhere close to the AT&T proposal. For example, when the Commission first adopted price cap regulation for ILECs in 1990, a change designed to make interstate switched access rates more efficient, it declined to lower the ILECs' rates. Instead, the Commission adopted a "starting point for the indexing of rates" based on the rates set under rate of return regulation.[3] In addition, as part of the price cap mechanism, the Commission adopted only a modest productivity offset "to balance fairly the interests of customers and LEC shareholders…." *Id.* ¶ 76. This so-called X-factor has changed somewhat over the past ten years, but it has never required that ILEC interstate access rates be reduced by more than 6.5 percent per year (net of inflation). Furthermore, the Commission included a low-end adjustment in its price cap plan to ensure that ILECs were prevented from experiencing low rates of return (*i.e.*, below 10.25%).[4]

Nor did the Commission's approach to lowering ILEC rates change significantly after the passage of the 1996 Act and the introduction of local competition. In its first order in the above-referenced docket, the Commission declined to pursue a prescriptive approach to rate reductions, but instead opted for a primarily market-based approach that would gradually reduce rates in response to competitive pressures.[5]

Most recently, in the CALLS Order the Commission adopted a somewhat more prescriptive approach to rate reductions. CALLS was a voluntarily negotiated agreement by the participating ILECs and long distance carriers. It should come as no surprise, therefore, that the plan actually left ILECs in a better financial position at the end of the day than would have been the case had existing regulations remained in place. In the first year of CALLS, the participating

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[3] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶ 230 (1990) ("*Price Cap Second Report and Order*").

[4] *See Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, ¶ 127 (1997); *Price Cap Second Report and Order* ¶¶ 147-49.

[5] *See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing, End User Common Line Charges*, First Report and Order, 12 FCC Rcd 15982, ¶ 263 (1997) ("*Access Charge Reform First Report and Order*"). This market-based approach was the correct course to take, and the undersigned have long supported it. But it nevertheless offers yet another illustration of the Commission's unwillingness to introduce any dramatic changes in ILEC interstate access rates.

ILECs did lower their per minute switched access charges an aggregate of $2.1 billion.[6] This reduction represented about a 35 percent reduction in the per minute rates.[7] But when all of the ILEC access rate elements are accounted for (including revenues from flat monthly charges), the overall ILEC revenues were reduced by only $700 million in the first year of CALLS, a tiny amount given the size of the companies affected. *See CALLS Order* ¶ 41. Moreover, during the course of the five-year plan, most ILECs are allowed to more than make up for this reduction. This is because the X-factor is eliminated once an ILEC reaches the target per minute rate under the plan (which many of the ILECs reach in the first two years). In fact, the Commission estimated that by the end of the plan, ILECs will receive an *increase* in revenues over and above what they would have otherwise received under regulations in place at the time CALLS was adopted. *See id.* Of course, some ILECs with relatively high per minute charges experience net reductions in revenues. But to prevent disruptive flash-cut reductions in these carriers' rates, the CALLS plan includes special protective measures to diminish the impact of the first-year reduction. *See id.* ¶¶ 154-56. The plan also allows these carriers a full five years to reach the target rate.

The Commission's consistent policy of preventing dramatic reductions in ILEC access rates over the past ten years (to say nothing of the regulatory approach under rate of return, if anything a more cautious approach), by itself mandates similar treatment for any rate reductions the Commission may decide to impose on CLECs. Any such reductions would necessarily be based on a conclusion that CLECs have taken advantage of a market failure in the switched access market, essentially the same justification used for regulating ILEC interstate access. The similar context demands similar treatment. Of course, the likely response to this argument is that CLECs are new entrants and should therefore be required to conform immediately to the rates of the ILEC serving the same geographic area, since that is what they would be forced to do in a competitive market. But this response lacks any merit for two fundamental reasons.

First, current ILEC rates are set by regulation, not market forces. It is impossible to know what rate ILECs would charge for access in a competitive environment.[8] In many markets contiguous ILECs serve geographic areas that are very similar. Yet in each of these urban areas,

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[6] *See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board on Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962, ¶ 151 (2000) ("*CALLS Order*").

[7] *See* Joint Comments of ALTS and Time Warner Telecom, CC Docket Nos. 96-262, 94-1, 99-249, 96-45 (Apr. 3, 2000) at 7.

[8] Nor could it be assumed that a dominant firm in an unregulated market (and one not characterized by a third party pays problem) would set prices equal to marginal cost. Absent regulation, a dominant firm would set prices based on a number of factors, such as the nature of barriers to entry, whether the incumbent firm believes it has a cost advantage over entrants (due to economies of scale and scope), etc. *See* F.M. Scherer & David Ross, *Industrial Market Structure and Economic Performance* 356-374 (3d ed. 1990). Under many circumstances, a dominant firm will choose to charge prices above the firm's marginal cost, even where such prices can be expected to lead to new or expanded entry. *See id.*

the Commission has permitted the different ILECs to charge different interstate access prices. The CALLS plan has introduced a measure of uniformity to ILEC rates, but it allows those ILECs with relatively high rates fully five years to reach the target rate (and some of the ILECs will never reach the target rate under the plan). This kind of gradual transition is appropriate for lowering CLEC access rates to the ILEC rate as well.

Furthermore, when federal policy makers, including the Commission, faced the question of how to establish the preconditions for competition in the long distance market, they did not force new entrants to compete with AT&T on an equal footing until the competitors were able to establish sufficient economies of scale and scope. Forcing CLECs to conform to ILEC rates on a flash-cut basis would be an arbitrary departure from this policy.[9] Indeed, the history of the Commission's gradual introduction of cost-based tandem switched transport rates paid by nascent long distance competitors demonstrates that the Commission has treated rate changes affecting new entrants in essentially the same manner as rate changes affecting ILECs.

As part of the *MFJ*, a transitional "equal charge per unit of traffic" requirement was established.[10] Under this rule, both new entrant long distance carriers and the incumbent AT&T paid the same price for transport between a POP and an ILEC end office, so long as the POP was within a defined geographic distance from the ILEC end office. The equal charge was deemed to be necessary since AT&T, due to its historic monopoly, had been able to establish economies of scale that allowed it to use more efficient means of transport (generally direct trunked transport to ILEC end offices) than was the case with new entrants (which used less efficient tandem switched transport). During a transition period that gave the new entrants a chance to build their own economies of scale, the equal charge per unit of traffic essentially shifted transport costs from the new entrants to the incumbent.

When the nearly eight-year transition period established under the *MFJ* expired in September 1991, the Commission was faced with the decision as to whether a fully cost-based transport pricing regime would be in the public interest. The Commission decided that it should eventually establish cost-based rates for tandem switched transport. However, it nonetheless adopted an interim rate structure that was not fully cost-based, based on its conclusion that it should "proceed cautiously in this area in order to ensure that [it did] not endanger the availability of pluralistic supply in the interexchange market."[11] Under the interim rate structure,

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[9] *See McElroy Electronics Corp. v. FCC*, 990 F.2d 1351, 1365 (D.C. Cir. 1993) ("[W]e remind the Commission of the importance of treating similarly situated parties alike or providing an adequate justification for disparate treatment."); *New Orleans Channel 20, Inc. v. FCC*, 830 F.2d 361, 366 (D.C. Cir. 1987) ("*Melody Music* and its progeny appropriately recognize the importance of treating parties alike when they participate in the same event or when the agency vacillates without reason in its application of a statute or the implementing regulations."); *Melody Music, Inc. v. FCC*, 345 F.2d 730, 733 (D.C. Cir. 1965).

[10] *See United States v. AT&T*, 552 F.Supp. 131, 233-34 (D.D.C. 1982) ("*MFJ*"), *aff'd sub nom., Maryland v. United States*, 460 U.S. 1001 (1983).

[11] *Transport Rate Structure and Pricing Petition for Waiver of the Transport Rules Filed by GTE Service Corp.*, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, ¶ 3 (1992) ("*Transport Rate Structure Report and Order*").

rates for entrance facilities and direct-trunked transport were made non-usage sensitive in accordance with cost-causation principles. In addition, the Commission established usage-based rates for tandem switching. However, ILECs were only allowed to recover 20 percent of their Part 69 tandem revenue requirements through the tandem switching charge. *See id.* ¶ 25. The Commission adopted this approach in significant part "to ease the impact of a rate structure change on small IXCs…." *Id.* To ensure that the new structure was revenue-neutral for ILECs, the Commission imposed the per minute transport interconnection charge ("TIC") equally on all IXCs interconnecting with a particular LEC end office. *See id.* ¶ 61. The TIC required long distance carriers that used direct trunked transport (mostly AT&T) to pay part of the cost of tandem switching used by the small long distance carriers. By 1997, the TIC represented approximately 70 percent of ILEC transport revenues, or approximately $3.1 billion.[12] In spite of the Commission's stated preference for a cost-based system, it concluded that this interim structure was needed to "allow[] IXCs time to prepare for a fully cost-based rate structure by reconfiguring their networks and taking other steps to eliminate network inefficiencies developed under the equal charge rule."[13]

In 1997, the Commission recognized that the TIC should be eliminated. But fully thirteen years after the *MFJ* established the equal charge per unit of traffic rule, the Commission still concluded that it would be extremely disruptive to carriers that purchase tandem switched transport to eliminate the TIC on a flash-cut basis. As a result, the Commission established a mechanism to "substantially reduce the remaining TIC over a short, but reasonable period." *Access Charge Reform First Report and Order* ¶ 213. Accordingly, the Commission mandated the reallocation of tandem switching costs from the TIC to the tandem switching rate element in three approximately equal annual steps, thus creating a total transition of nearly three years. *See id.* ¶ 218.

In light of the Commission's extremely measured and gradual transition to equal treatment of new and incumbent long distance service providers, it would be patently arbitrary to require anything approaching the flash-cut reduction to ILEC rates requested by AT&T. There is simply no principled basis for distinguishing the small long distance carriers that benefited from the long transition to full cost-based tandem switched transport (many of whom are now urging the Commission to lower CLEC access rates to the ILEC level as quickly as possible) and CLECs today. Both classes of competitors entered businesses characterized by substantial sunk costs with an incumbent that, due solely to the accident of a historical monopoly, possessed substantial economies of scale and scope. Just as the Commission deferred the imposition of full cost-based tandem switched charges for nascent long distance carriers, so now the Commission

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[12] *See Access Charge Reform First Report and Order* ¶ 210. The TIC included costs associated with other facilities beyond simply tandem switching. However, as explained below, the Commission viewed the tandem costs in the TIC to be significant enough to warrant a nearly three-year phase-in when cost-based rates for tandem switching were ultimately implemented.

[13] *Transport Rate Structure and Pricing*, Third Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 10 FCC Rcd 3030, ¶ 31 (1994).

must, at the very least, allow a reasonable transition before CLEC access charges equal the ILEC's in the geographic area in which the CLEC provides service.

Accordingly, TWTC, Allegiance, and XO propose that, consistent with the CALLS plan, any benchmark rates established by the Commission should be reduced gradually over a transition period to equal the remaining time left in the CALLS plan (which ends June 30, 2005) to reach the rate of the ILEC serving the same territory.[14] Under this approach, CLEC rates above the relevant benchmark level would be subject to mandatory detariffing while CLEC rates at or below this rate would be subject to permissive detariffing. IXCs would be required to purchase CLEC originating and terminating access where the CLEC's rates are set no higher than the relevant benchmark, and IXCs should be made subject to strict enforcement penalties for refusing to pay CLEC rates set at or below the benchmark.

A reduction in originating and terminating interstate access rates to 2.5 cents per minute in the first year of the plan would result in a very significant one-time reduction. ALTS has estimated that an initial rate of 2.5 cents would result in a reduction of approximately 60 percent (from 4.27 cents to 2.5 cents per minute) below current average CLEC access charges. *See* Comments of ALTS, CC Docket Nos. 96-262, 97-146 (Jan. 11, 2001) at 11. This reduction is far more significant in percentage terms than even the approximate 35 percent first-year reduction to per minute charges under the CALLS plan. Moreover, CLECs would be required to accept such reductions without the opportunity to recover the shortfall in subsequent years, as is the case under CALLS.

Significantly, AT&T has implicitly conceded that 2.5 cents is an appropriate starting point for bringing CLEC access charges in line with ILEC rates.[15] The adoption of the 2.5 cent benchmark would also address AT&T's complaint that "CLECs with the highest traffic volumes are often the most abusive in tariffing their switched access services at supracompetitive levels." AT&T Jan. 11, 2001 Comments at 7-8. There would be no room for such outlier behavior under the plan proposed here.

Furthermore, establishing the remaining time period in CALLS as the transition period for the reduction of CLEC access rates is eminently reasonable. CLECs would experience far

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[14] The Commission must affirm that any benchmark rates adopted do not represent a judgment as to the reasonableness or lawfulness of prior CLEC access rates. Moreover, the Commission must ensure apples-to-apples comparisons between CLEC and ILEC rates. A CLEC must be permitted to demonstrate in support of a tariff filing that its effective per minute access rate, taking into account differences in rate structure, is equal to the ILEC's. Also, where a CLEC serves an area that is served by several different contiguous ILECs, CLECs must be given some flexibility to adopt weighted average interstate switched access rates for the entire territory. The weighting could, for example, be based on the percentage of access lines (or equivalent) served by the CLEC that are in each of the ILEC regions in question.

[15] *See* AT&T Additional Comments, CC Docket Nos. 96-262, 97-146, CCB/CPD File No. 98-63 (Jan. 11, 2001) at 7 (classifying CLEC access rates in three categories: those above the ILEC rate, those above 2.5 cents per minute, and those over 5.0 cents per minute); Additional Reply Comments of AT&T Corp., CC Docket No. 96-262 (Jan. 26, 2001) at 6 (singling out CLECs with access charges "over 2.5 cents per minute" as "high priced").

greater rate reductions over a shorter time period than any of the ILECs subject to CALLS.[16] Moreover, a transition of slightly longer than four years is more reasonable in this case than the nearly three-year transition granted for tandem switched transport in 1997, because CLECs have not had the benefit of anything close to the prior lengthy transition granted to the small long distance carriers. The transition proposed herein would also grant CLECs much needed regulatory certainty, which was one of the most compelling aspects of the CALLS plan for the parties that negotiated that agreement. Indeed, AT&T itself urged this Commission to adopt the five-year CALLS plan precisely because the plan offered a period of regulatory certainty.[17]

Although AT&T alleges that a gradual reduction in CLEC access charges could result in inefficient entry, *see* AT&T March 22, 2001 Letter, AT&T has never demonstrated that CLEC rates are unreasonable. So AT&T cannot claim that existing CLEC rates, nor rates that transition to ILEC rates over slightly more than four years, result in inefficient entry. Nonetheless, the steep initial reduction in rates and the significant reductions in each subsequent year are unlikely to offer an inefficient entrant any opportunity to profit from some form of "hit and run" entry. At the same time, the plan allows CLECs enough time to adjust to the new environment at a time when the broader market conditions are extremely difficult.

Finally, the transition proposed herein is even more compelling when considered in light of the Commission's apparent plan to mandate lower rates for the exchange of ISP-bound traffic. The change that the Commission is apparently considering would result in an approximate $1.5 billion reduction in CLEC revenues over three years. When added to that reduction in revenues, a flash cut to ILEC switched access rates as proposed by AT&T would be draconian and completely inconsistent with the manner in which the FCC has treated the ILECs as well as growing competition in the long distance market. The plan proposed herein would in contrast allow CLECs adequate time to adjust their businesses without extending the transition period excessively.

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[16] It is noteworthy that the so-called multi-association group or "MAG" plan for reforming medium to small ILEC access rates also includes a five-year transition period. *See Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers; Federal-State Joint Board on Universal Service; Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation; Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, Notice of Proposed Rulemaking, FCC 00-448, ¶ 1 (rel. Jan. 5, 2001).

[17] *See* Comments of AT&T Corp. in Support of the Coalition for Affordable Local and Long Distance Service Proposal, CC Docket Nos. 94-1, 96-45, 96-262, 99-249 (Nov. 12, 1999) at 19-20; Letter from John T. Nakahata, Counsel to the Coalition for Affordable Local and Long Distance Services to Ms. Magalie Roman Salas, CC Docket Nos. 96-45, 96-262, 94-1, 99-249 (July 29, 1999) (submitting five-year CALLS plan endorsed by all CALLS members including AT&T).

Pursuant to Section 1.1206(b)(1) of the Commission's rules, 47 C.F.R. § 1.1206(b)(1), an original and one copy of this letter are being provided for inclusion in the public record of the above-referenced proceeding.

Sincerely,

/s/
Kevin Joseph, Vice President
Government Affairs
Allegiance Telecom

/s/
Kelsi Reeves, Vice President
Federal Government Relations
Time Warner Telecom

/s/
R. Gerard Salemme, Senior Vice President
External Affairs
XO Communications

cc: Dorothy Attwood
Scott Bergman
Rebecca Beynon
Kyle Dixon
Jeff Dygert
Jordan Goldstein
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